

**REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE  
TREASURY BORROWING ADVISORY COMMITTEE  
OF THE  
BOND MARKET ASSOCIATION**

May 2, 2006

Dear Mr. Secretary:

Since the Committee's last meeting in February, the economic expansion has displayed continued resilience in the face of persistently high energy costs. Real GDP expanded at a solid 4.8% annual rate in the first quarter, partly reflecting the rebound from last year's hurricanes and a relatively mild winter. Recent readings reveal healthy improvements in employment and new orders for capital goods in March. Rising interest rates have begun to cool housing markets, but the financial backdrop remains reasonably supportive of trend-like economic expansion over the balance of 2006.

Energy markets are an ongoing concern for the economy. Crude oil prices have surged past \$70/bbl for West Texas Intermediate as refiners and others continue to hedge against the risk of supply disruptions. Gasoline markets remain stretched with prices in April nearing post-Katrina highs, up 20% in the past month. Consumer anxieties about gasoline prices have been offset in part by continued good news from labor markets where monthly payroll gains averaged 197,000 in the first quarter and the jobless rate eased to an expansion low of 4.7%. Similarly, corporate profits continue to rise at a double-digit pace. As of April 28, with more than two-thirds of S&P 500 companies reporting, 85% had met or exceeded expectations for the first quarter.

Headline inflation has remained elevated in recent months, primarily reflecting the jolt from higher energy costs. Core measures have held near 2%, as the pass-through from higher energy and material prices has been limited. Despite tightening labor markets, compensation gains have been moderate and solid productivity appears to be buffering potential cost pressures. Risks of greater price pressures still exist because the cumulative rise in energy costs remains a broader threat, while declining economic slack could raise costs for labor and other resources.

Against this backdrop, yields on U.S. Treasury securities have risen about a half percentage point to new cyclical highs across the maturity spectrum. While forward rates have firmed in anticipation that additional Fed tightening could carry overnight rates to 5 1/4%, the selloff also suggests that the unusual decline in term premiums of recent years may be reversing amid new uncertainties about the path of global interest rates. Longer-dated yields have topped 5% for the first time in four years and the curve has shifted from a slight inversion to a positive slope from two- to ten-years' maturities.

Just past the halfway point, the 2006 Federal budget deficit is running along a path comparable to the previous fiscal year, or about 2 ½% to 2 ¾% as a percent of GDP. Tax receipts are climbing at a solid clip but public spending, especially on health care, also is rising rapidly.

Against this economic and financial backdrop, the Committee considered its charge. In the first section, Treasury presented a framework for evaluating its portfolio composition. Treasury asked the Committee for its views with respect to the applicability of this framework in contemplating future debt management policy choices and for suggestions on how to further develop associated guidelines on portfolio composition.

Charts were presented listing the goals of optimization including minimization of expected costs over time, variability of interest cost over time, operational risks and the maximization of primary and secondary market liquidity. Treasury described its three stage project outline and its goal of creating an optimizer that could be used for future liability management policy in a cost minimizing fashion.

Members commented on the proposal's perceived benefits such as the added value this approach would bring to bear on risk management scenario analysis as well as greater transparency.

A member asked if constraints were being considered for inclusion in the model, such as targets for the average maturity of the debt portfolio. Another recommended a constrained optimization approach as the preferred course. One member suggested that it might be difficult to measure the cost of factors such as rollover risk and liquidity. Members agreed that sensitivity around many needed assumptions or inputs would be a limiting factor. Others suggested that the asset side of the balance sheet should be taken into consideration for duration purposes. Treasury stated a desire to present its framework more substantially in August.

In the second part of the charge, Treasury asked for the Committee's views on the establishment of a securities lending facility. Treasury asked the Committee to discuss aspects of a white paper outlining the construct of a Securities Lender of Last Resort (SLLR) facility which they have recently authored and distributed. In particular, Treasury asked for comment on the potential costs and benefits as well as the proposed structure envisioned in the paper. Treasury officials took pains to inform the Committee that the establishment of the facility would most likely require a change in statute and that implementation was not a forgone conclusion. Additionally, Treasury reported that mixed opinions are prevalent among a broad group of market participants they have polled on the subject. The Committee's views were similar in their diversity and consensus opinions were not evident post discussion. Several members felt that the market has moved to address chronic fail potential and that further official influence would not be welcome. These members felt that additional expenses associated with implementation would be additive to an already high cost base associated with maintaining fully compliant Treasury Dealerships. Additionally they articulated views suggesting that auction taps, large position reporting and suasion were ample deterrents against chronic fails, and as

such, saw little need to add another protective measure. A member felt that Treasury borrowing costs would clearly rise with implementation due to a perception of less scarcity value associated with predictably higher repo rates. Other members felt that establishment of the proposed facility would allow for unwanted administrative intrusion which could lead to a deterioration in market efficiency. Another member suggested that the facility be readied in advance of a time when it could be more obviously needed. A member, argued that in nearly all instances the proposed facility would not be needed. As such, the member suggested that a fairly rigid set of implementation guidelines be included in any proposed legislation that Treasury might draft, so to limit by design, the potential for interference. Other members acknowledged perceived benefits from the proposed SLLR but were quick to voice concerns about any facility which might advance arbitrary administrative decisions. In sum, views as to the proposed facility's worth and construct differed but were roughly in balance.

In the third part of the charge, Treasury asked for the Committee's views on the bond auction cycle and whether or not it should be changed in order to assure a liquid STRIPS curve and meet expected demand from a variety of sources. Treasury specifically asked for comment on whether or not the Committee felt a May-November bond auction cycle should be added to the current schedule. Members expressed support for the introduction of a May-November cycle citing expected secular demand increases from pension managers for long duration fixed income products over the coming years. They stated that a high demand profile for long Treasuries will likely remain a feature from this type of buyer for the foreseeable future and that ensuring a steady supply will attract more buyers and lower borrowing costs over time. While they felt that Treasury had no need to change its auction cycle in the near term, most members felt that moving to a quarterly cycle would be the best choice at some point. Given Treasury's stated desire to not increase bond supply dramatically in the near term, one member cautioned against a quarterly cycle where auction sizes would be too small to ensure liquidity and normal borrowing costs for short sellers. Members also discussed additional long duration issuance as an option for Treasury, namely floating rate and 50-year bonds, but cautioned Treasury to not pursue any near term changes in products offerings.

In the final section of the charge, the Committee considered the composition of marketable financing for the April-June quarter to refund \$59.9 billion of privately held notes and bonds maturing or called on May 15, 2006 as well as the composition of Treasury marketable financing for the remainder of the April-June quarter, including cash management bills, as well as the composition of Treasury marketable financing for the July-September quarter. To refund \$59.9 billion of privately held notes and bonds maturing May 15, 2006, the Committee recommended a \$21 billion 3-year note due 5/15/09 and a \$13 billion dollar 10-year note due 5/15/16. For the remainder of the quarter, the Committee recommended a \$22 billion 2-year note in May and June, a \$15 billion 5-year note in May and June, and a \$9 billion reopening of the 10-year note in June. The Committee also recommended a \$15 billion 13-day cash management bill issued June 2, 2006 and maturing June 15, 2006 as well as an 8-day cash management bill issued June 7, 2006 and maturing June 15, 2006. For the July-September quarter, The

Committee recommended financing as found in the attached table. Relevant features include three 2-year note issuances monthly, three 5-year note issuances monthly, one 3-year note issuance in August, a 10-year note issuance in August with a reopening in September, a reopening of the 30-year bond in August, as well as a 10-year TIPS issuance in July and a 20-year TIPS reopening in July.

Respectfully submitted,

Ian G. Banwell  
Chairman

Thomas G. Maheras  
Vice Chairman

Attachments (2)